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Dividends and depletion of wasting assets

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Unremitting agitation and representation on the part of accountants have had the effect here and there, in cases highly isolated, of influencing certain corporations to change their fiscal years so that the accounts would be closed at some date other than December 31. The books and articles on the subject which have been written perhaps have made some impression, but, generally speaking, progress in the direction of a substantial change has been exceedingly slow if, in fact, any real progress has been made.

Now, however (October, 1927), comes the Associated Fur Manufacturers, Inc., of New York, and voluntarily votes to change its fiscal year so that the year will end in March instead of December. This plan is stated to be in accordance with a resolution adopted by the National Association of the Fur Industry at a convention previously held in Chicago. The principal point of interest in the change is the fact that this industry reached its conclusion of its own free will, on the basis of sound logic resulting from introspection and the application of common business sense.

It appears there had grown up in the industry a practice of marking down prices and giving unreasonable discounts in order to raise cash with which to meet obligations maturing at the end of the calendar year, although this action was taken at the height of the fur-selling season. Looking into the matter carefully, the fur people realized that it would be more economical to carry through to the end of the fur-selling season and stand the expense of the borrowed capital necessary, than to suffer the losses attendant upon the slashing of prices. The conclusion seems so sensible and so simple that it is difficult to understand why the thought had not occurred to some one in the fur industry long before October, 1927.

This voluntary action on the part of the fur industry promises much for the future. Once an industry awakens to the realization that it has something to gain by changing its fiscal year, and that such action is not merely an accommodation to public accountants, the motive for changing is much more impelling than any agitation or force which can be applied from without.

The hope for the future lies in the fact that the change has been inaugurated by industry itself. With this splendid beginning, it is not unlikely that other classes of industry will see the advantages to be gained by changing and that others will follow suit.

Dividends and Depletion of Wasting Assets

WASTING assets have been defined as "material assets, such as mines, which diminish in value by reason of and commensurately with the removal of their product, or immaterial assets, such as patents, which theoretically diminish in value by reason of and commensurately with effluxion of time." That is, they are assets which must be consumed or depleted in the course of business in order to produce revenue. Although accountants may not be in entire agreement as to whether depreciation is an element of cost, they are generally in accord in regarding depletion as a part of cost. It is difficult to conceive how depletion can be regarded as anything else than a part of the cost of goods sold, just as are royalties and raw materials consumed.

Notwithstanding the fact that depletion is generally regarded as an element of cost, certain state legislatures hold that it is unnecessary to provide for depletion before declaring dividends. Some states which have enacted laws prohibiting the payment of dividends without providing for depreciation, have made exceptions in the case of corporations operating wasting assets, permitting such companies to pay dividends without providing for depletion of wasting property. To be sure, many accountants who maintain that depletion is a cost, also advocate the policy of distributing, as dividends, the entire profit from the sale of wasting assets without making allowance for depletion. The adoption of such a policy may be traced to the decision, in 1889, in the English case, *Lee v. Neuchatel Asphalte Company, Limited.* Prior to that time accountants were generally agreed that provision should be made for depletion before paying dividends.

In the Lee case an action was brought by a shareholder of the Asphalte Company to enjoin that company from paying dividends without making allowance for the depletion of the asphalt deposits. The company had been organized for the purpose of acquiring a short-term concession to work some asphalt deposits in Switzerland. The articles of association did not provide for establishing a reserve for depletion in the value of the concession. The court decided that in such cases the articles of association are controlling; that if the articles of association of a company organized to acquire and work a wasting asset do not provide for allowance for depletion, the capital expended in acquiring the asset may be regarded as sunk and gone, and the excess of receipts over expenses distributed among the stockholders provided the assets retained in the business are sufficient to pay debts.

English law continues to allow dividends to be paid without providing for depletion of wasting assets. In fact, even the English income tax law does not allow depletion as a deduction from taxable income. The income tax law of the United States does recognize depletion as a cost and allows taxpayers to deduct from gross income "a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case."

Although it is legal in most states for corporations to declare and pay dividends which include not only profits of the business but also a return of part of the capital originally invested in wasting assets, it is, nevertheless, contrary to sound and conservative accounting practice. It is a principle of economic theory that dividends may not be paid out of capital. Many of the states have written this principle into their statutes. Yet many of these same states make exceptions in the case of wasting assets and allow return of capital invested in such assets.

Business today is conducted on a large scale, and most business concerns intend to continue in existence indefinitely. Consolidation and integration of industry have resulted in large companies acquiring the properties from which they obtain their raw materials. Large iron and steel companies own coal and iron mines. Few business enterprises are now organized as single ventures. The corporations of today are of a more permanent character. To maintain such permanency, the principle of preservation of capital must be applied to wasting assets as well as to fixed assets Depletion must be deducted before determining profits available for dividends, just as depreciation on the fixed assets of a business must be deducted.

The ownership of business today is no longer confined to a few individuals but is distributed among a host of security holders. Most investors, especially the smaller ones, regard cash dividends from stock in any company as being representative entirely of income. Even investors in mining companies, although they should be forewarned, are prone to regard the dividends from such companies as profits and treat them as such. Conservative accounting requires that the interests of all parties concerned be safeguarded. Therefore, it is the duty of accountants to advocate that the capital of a business be kept intact, and, of course, an accountant could not be expected to certify to a balance sheet in which the value of the wasting assets has not been reduced by the amount of depletion suffered.

The argument generally advanced by those who advocate the payment of dividends without provision for depletion is that the exploitation of wasting assets is by its very nature a temporary activity, and that consequently investors are on notice that their capital will not remain intact. They argue that the proceeds from the exploitation of the wasting assets should be turned back to the investors as soon as possible rather than be invested, in part, in a trust fund to be held until the assets are fully depleted and the business liquidated. Assuming that the business is a temporary one and that the receipts withheld for depletion are to be invested in a sinking fund rather than used to develop the business, it is conceivable that the funds might be used more profitably by returning them to the stockholders. However, unless the stockholder clearly understands that the dividends he receives include both profit and a return of capital, such a policy is obviously unfair to him. He might easily dissipate his investment and savings because of a misconceived idea that the dividends represent income only.

Strenuous objections have been raised, at different times, to the use of capital stock having a par value. The reason given for the objection has been that the par value tended to mislead investors into thinking that the stock was actually worth its face value. However, they may be misled much more easily by the balance sheet of a company which carries its capital and wasting assets at the full value, but which has allowed its real capital to be reduced by the payment of dividends without providing for the depletion of the wasting assets.

Granted that in the case of companies temporary in character, which are organized to exploit their original holdings and then liquidate, it is often the best policy to return as dividends not only profits from operations, but also the capital invested in wasting assets as soon as it is converted into current assets, provided, of course, that sufficient assets are retained to pay debts. But, few companies operating wasting assets can be regarded as temporary. Most of the large corporations which own natural resources do not confine their operations to a single bed of ore or to one deposit of minerals. They do not intend to liquidate as soon as their present or original holdings are exhausted. They are continually acquiring new properties and doing research and development work so that their business may continue indefinitely. Although the corporation may legally declare dividends without providing for depletion, it is certainly the duty of the public accountant to point out to the directors that the continuity of the business requires that the capital remain intact, even in the case of a company working wasting assets.

There are at least three types of state laws regulating the payment of dividends out of profits on wasting assets. Delaware, as might be expected from the many other liberal provisions in its corporation law, allows the payment of dividends from profits without deductions for depletion of wasting assets. The Delaware law states, "Subject to any restrictions contained in its Certificate of Incorporation, the directors of any corporation engaged in the exploitation of wasting assets may determine the annual net profits derived from the exploitation of such wasting assets without taking into consideration the depletion of such assets resulting from lapse of time or from necessary consumption of such assets incidental to their exploitation." As one author has said, "the Delaware law might be said to permit anything which finance, high or low, may see fit to undertake."

On the other hand, the Wisconsin law, which, generally speaking, sanctions nothing but practices approved by sound economic doctrine, provides that dividends may be paid " . . . only out of net profits properly applicable thereto, and which shall not in any way impair or diminish the capital." The Wisconsin law upholds the economic axiom of preservation of capital.

The Ohio law recognizes the principle of preservation of capital and at the same time provides for the temporary company operating wasting assets. Under the General Corporation Act of Ohio, in determining the surplus available for dividends, proper allowance must be made for depletion, unless a corporation which owns or intends to own wasting assets provides in its articles that the depletion of such assets by sale or lapse of time need not be deducted in the computation of surplus available for dividends. In such a case the corporation may pay dividends without deduction of depletion.

The Delaware law represents the liberal attitude with regard to dividends; the Wisconsin law the conservative treatment compatible with good economic theory. The Ohio law seems to meet the demands of both liberal and conservative practice by requiring that a corporation which does not intend to provide for depletion declare that intention in its articles of incorporation, and thus put investors on notice that the operations of the company are to be temporary in character and that any dividends received may consist partly of profits and partly of a return of capital. No matter what the state law may allow, accountants should not accept the theory that for all companies exploiting wasting assets depletion need not be deducted in determining surplus available for dividends. It should be the accountant's duty always to uphold conservative accounting practice.

News Items

Mr. Kracke has returned to this country after a period of three years spent in Europe, principally on engagements involving foreign financing by American bankers, and will devote his attention to general practice matters.

Mr. Wildman addressed the American Association of University Instructors in Accounting, in Washington, D. C., on December 28, 1927, on the subject "Classification of Accountancy Services."

Mr. Wildman also addressed the New York State Society of Certified Public Accountants, on January 9, 1928, in New York City, on the subject of "No-Par Stock."

Mr. L. P. Gallagher, manager of our Chicago office, recently was admitted to membership in the American Institute of Accountants. He also has become a member of the Illinois Society of Certified Public Accountants.

Mr. W. E. Nissen, manager of our Salt Lake City office, recently was re-elected vice-president of the Utah Association of Certified Accountants.

The following men from our various offices are to be congratulated upon passing the C. P. A. examination of the states indicated: Mr. J. L. Taylor (Illinois), Chicago office; Mr. C. L. Dahlin (Colorado), Denver office; Mr. J. J. Shrewsbury (Colorado), Denver office; Mr. J. N. Stranford (Pennsylvania), Philadelphia office; Mr. R. S. Angle (Pennsylvania), Phi adelphia office; Mr. C. A. Zukschwert (New Jersey), Newark office; Mr. C. H. Ritchie (Minnesota), Minneapolis office; Mr. R. W. Weikel (Pennsylvania), Philadelphia office; Mr. A. W. Tolman, Jr. (Maine), New York Thirty-ninth Street office.

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